United States Court of Appeals

for the Second Circuit

APPELLEE’S BRIEF

76-7428

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

B

P/S

76-7428

HOWARD C. HIRSCH, PAUL L. KOHNS and MARSHALL S. MUNDHEIM,

Plaintiffs-Appellants,

—against—

EDMOND duPONT, WALLACE C. LATOUR, MILTON A. SPEICHER, FRANCIS I. duPONT & CO., F. I. duPONT GLORE FORGAN & CO. and duPONT GLORE FORGAN INCORPORATED,

Defendants,

and

HASKINS & SELLS and NEW YORK STOCK EXCHANGE, INC.,

Defendants-Appellees.

On Appeal from the United States District Court for the Southern District of New York

BRIEF FOR DEFENDANT-APPELLEE NEW YORK STOCK EXCHANGE, INC.

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Issues Presented for Review

The basic issue on this appeal is whether the essential findings of fact are supported by the evidence. The trial court evaluated the testimony and other evidence concerning the knowledge, experience, disclosure and warnings given to plaintiffs. It found that "the current condition of FID was fully disclosed to plaintiffs or their representatives." (Op.[1] 15; 94a[2]) The trial court also found that

1. "Op." refers to the designated pages of the trial court's opinion dated June 30, 1976 reprinted in the Joint Appendix.

2. "a" refers to the designated pages in the Joint Appendix.

"there is nothing in the record to indicate that the NYSE participated in any way (advised, encouraged or brought the parties together) in the merger negotiations", and that "there is little doubt that NYSE was fully entitled to conclude that plaintiffs had fully informed themselves concerning all the facts relating to FID and had decided to go forward with the merger, fully advised of all the facts" and that "there was no non-disclosure or otherwise any 10(b) fault on NYSE's part." (Op. 12, 14, 19; 91a, 93a, 98a) If this Court concludes that the evidence, when taken as a whole and considered in a light most favorable to defendants, is sufficient to support these findings of fact, the judgment of the trial court should be affirmed. Subsidiary issues are:

1. Does New York Stock Exchange, Inc. (the "Exchange") have any liability to plaintiffs based upon statements or omissions allegedly made by others without the knowledge of the Exchange?

2. Are plaintiffs barred by the principles of waiver and estoppel from asserting any claim against the Exchange?

3. Was plaintiffs' loss proximately caused by the alleged fraud?

4. Can plaintiffs recover without submitting any proof of damages?

5. Did the trial court properly exercise its discretion in denying plaintiffs' motion to amend their amended complaint on the first day of trial to add a Section 6 claim or otherwise permit plaintiffs to pursue such a claim?

6. Did plaintiffs Kohns and Mundheim have any federal securities law claim?

Statement of the Case

This is an appeal from the judgment and order of the United States District Court for the Southern District of

New York, Hon. Robert L. Carter, entered on August 3, 1976, and based on an opinion dated June 30, 1976 (78a-99a), dismissing after trial all claims against the Exchange and Haskins & Sells. (1098a-1099a)

On July 2, 1970, plaintiffs signed a merger agreement under which Hirsch & Co., Glore Forgan & Co. ("Glore") and Francis I. duPont & Co. ("FID") merged to form the succeeding partnership of F. I. duPont, Glore Forgan & Co. ("FDGF"). (321a) The agreement provided for an assumption of all liabilities of Hirsch & Co. by FID; the prior acquisition of Glore by FID; and a contribution of at least $4,000,000 in capital by the Hirsch partners. In November of 1970, FIDGF was required by the Exchange to raise additional capital or liquidate its security positions to comply with Exchange net capital requirements. Shortly thereafter, plaintiffs' investments in the merged firm were changed from general and limited partnership interests to subordinated loans to be repaid on dates certain in the future. Plaintiffs withdrew portions of their investments under the subordinated loan agreements and the remainder of their investments was consumed to support the business of the firm.

Plaintiffs filed their complaint on February 23, 1972. On April 26, 1972, the Exchange moved for a more definite statement requesting, among other things, that plaintiffs plead the statutory basis upon which they sought to recover from the Exchange. On June 28, 1972, the Exchange's motion was granted (1089a) and on July 13, 1972, plaintiffs filed an amended complaint pleading one claim by all plaintiffs against all defendants based on Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), the rules and regulations thereunder, Section 17 of the Securities Act of 1933, 15 U.S.C. § 77q, and common law fraud, intentional and negligent misrepresentation, and breach of fiduciary duty. (10a)

Plaintiffs alleged that during negotiations between plaintiffs and the partners of FID prior to July 2, 1970,

plaintiffs were the victims of untrue statements and omissions by FID, FIDGF and certain partners of FID named as individual defendants[3] in respect to the condition of FID. It was alleged that Haskins & Sells was responsible for the issuance of certain false financial statements in respect to FID on or before July 1, 1970, upon which plaintiffs relied. The Exchange was charged with knowledge of the misrepresentations or omissions allegedly worked upon plaintiffs by FID, FIDGF and the individual defendants, and failure to warn plaintiffs.

Both Haskins & Sells and the Exchange denied the material allegations of the amended complaint and cross-claimed against the other defendants for indemnification and contribution.

Haskins & Sells and the Exchange then moved for summary judgment on the ground that the interests in FIDGF sought to be recovered by plaintiffs Kohns and Mundheim were not securities under the federal securities laws. By opinion dated June 5, 1975, 396 F.Supp. 1214 (S.D.N.Y.), the district court granted the motion to the extent of dismissing the Section 10(b) and Section 17 claims of Kohns and Mundheim with respect to their general partnership interests. (28a-77a) The district court denied the motion with respect to Kohn's and Mundheim's limited partnership interests and as to all interests for which they sought recovery on state law theories.

On June 17, 1975, the first day of trial, plaintiffs moved for leave to file a second amended complaint adding a claim against the Exchange under Section 6 of the Exchange Act. The trial court exercised its discretion to deny the motion on the ground of fairness. (1123a-1124a)

Following conclusion of the trial, the court by opinion dated July 18, 1975, dismissed all cross-claims which had

3. Pursuant to the settlement of a state court contract action, plaintiffs dismissed with prejudice all claims against all defendants except Haskins & Sells and the Exchange. The amended complaint contains a second claim by all plaintiffs against the dismissed defendants only, which is thus moot.

been asserted by Haskins & Sells and the Exchange against the remaining defendants. (1091a) The trial court said:

> "The evidence is undisputed that nothing was withheld from the plaintiffs by duPont or any of its partners or by any defendants against whom a cross-claim has been filed. Plaintiffs received whatever they asked for, and none of the evidence supplied was false or misleading or tended to give plaintiffs a false picture of duPont's financial status." (1094a-1095a)

On June 30, 1976, the court rendered its opinion dismissing all claims against the Exchange and Haskins & Sells. (78a)

Statement of the Facts

The trial court found that the plaintiffs were all sophisticated and knowledgeable business men with lengthy experience in the brokerage business as partners in Hirsch & Co. (Op. 3, 82a) By the end of 1968, Howard Hirsch was anxious to retire completely and had, in fact, begun to withdraw some of his capital from the firm. (2151a, 2154a; Op. 3, 82a) By mid-1969 Mundheim decided that he, too, wished to retire. (2023a) With his departure, a large part of the firm's capital would disappear, leaving Hirsch & Co. and the younger partners in an untenable position. (275a) In later 1969, another principal capital contributor, Maurice Meyer, Jr., expressed the desire to withdraw from the firm, but was prevailed upon to leave his capital in as limited partnership capital. (*id.*) The effect of Meyer's change of status was to place the burden for future losses on the remaining general partners to a proportionately greater degree. (1841a-1842a)

The troubles of the Hirsch firm in 1969-1970. From late 1967 through early 1969, the most active securities market in history overwhelmed the industry's paperwork processing capacity. (1305a-1306a) Hirsch & Co. was not immune to these problems. The year 1969 was the first year the Hirsch firm registered an operating loss. (2155a) In 1969, firm

losses ran to approximately $2.8 million. (768a) The investment of each partner was eroded in proportion to his interest in the firm. Hirsch, Kohns, and Mundheim were among the largest capital contributors. Kohns' 1969 loss was $445,678.06; Mundheim's was $333,736.52; and Hirsch's was $239,366.38. (*id.*) Maurice Meyer lost $444,221.12, which makes clear why he wished to and did resign as a general partner as of year-end. (1804a)

In early 1969, the firm was threatened with Exchange sanctions for violation of the Exchange's Rule 282. (1865a-1869a, 690a) This violation was created by the large fail balances and differences existing in the firm's back office. (*id.*) An Exchange examiner's visit also pointed out that the Hirsch firm had substantial security count differences at the end of 1968.[4] (690a) Again, in 1969, the Hirsch firm was placed on the Exchange's disciplinary report for poor supervision and control in some of its branch offices. (680a) The firm was also admonished for poor supervision and negligence which permitted the firm's chief margin clerk to embezzle $65,000. (1869a) As a result of an Exchange examiner's visit in January and February of 1970, the Exchange sent a letter to Kohns alerting him to a number of errors in Hirsch & Co.'s computation of its net capital position, and to the fact that when these errors were corrected, the resulting net capital ratio of the firm was 1,715%, well above the warning 1,500% guideline.[5] (688a, 690a) Kohns was warned about Hirsch & Co.'s vulnerability to a capital

4. A long security count difference occurs when a brokerage firm is physically in possession of a security for which it has no identifiable owner on its stock record. A short security count difference is the opposite; the firm has an entry on its stock record indicating that it should have the security but cannot physically locate the security. (1143a-1145a) Such differences were virtually unknown before the paperwork crunch. (1312a) Subsequently, when they occurred, they were resolved by research in most cases. (1312a-1313a)

5. The Exchange's net capital Rule (Rule 325) prescribed that a firm's aggregate indebtedness could not be greater than 20 times its "net capital" (2,000%) as defined by the rule. The concept of net capital was designed by the Exchange to provide an artificial measure [con't]

violation and told that the firm should take steps to maintain its net capital ratio within the Exchange's safety margins. (*id.*)

With the continuing losses suffered by the Hirsch firm in 1969, it became obvious to plaintiffs that the firm could not continue to exist in its present form. (1803a, 2023a-2024a, 2069a-2073a) The Hirsch partners believed that with the heavy trading volume, which required expensive data processing equipment, and the subsequent income downturn in the securities industry, a firm the size of Hirsch & Co. had no place in the business. (*id.*) The firm did not have the trading volume, nor the customer accounts, to support these operating expenses. (Op. 3-4, 82a-83a)

Merger as a way out of difficulty for plaintiffs. The Hirsch partners considered merger to be a way out of their bind. (*id.*) From mid-1969, merger discussions were pursued unsuccessfully by Hirsch & Co. with Newberger & Co.; Robinson & Co.; Bioren & Co.; Hentz & Co.; Shearson Hammill & Co.; Cogan, Berlin & Weil; Cohen & Simonson; A. G. Becker and Bache & Co. (1721a-1727a, 2063a-2065a) During the course of a number of their discussions, Hirsch & Co. instructed its comptroller, Frank Gariboldi, to study the books and records and financial condition of the proposed merger candidate. (1721a-1727a) Gariboldi was particularly well qualified to make such an analysis. Prior to joining Hirsch & Co. in 1960, Gariboldi had been a senior accountant specializing in brokerage audits with Haskins & Sells. (1303a-1305a) While with Haskins & Sells, Gariboldi had worked on an audit of FID (1694a), and had been the accountant in charge of an audit of Merrill Lynch. (1303a-1304a) As comptroller of Hirsch & Co., Gariboldi had charge of all financial reports for the firm and all reports to regulatory bodies. (1678a-1679a)

[footnote con't]

of a firm's liquidity, or ability to reduce an asset to cash within 30 days. Net capital does not include many fixed assets commonly thought of as part of capital, such as furniture, fixtures, and stock exchange seats. The concept that measures the worth of the business is called Net Worth. 2 CCH NYSE Guide ¶ 2325 (1970)

The troubles of FID in 1969-1970. FID had been founded in 1931 (394a) by members of the family which owned and controlled E. I. duPont deNemours & Co. In early 1970, the duPont family continued as the principal owners and capital source of FID. Edmond duPont was the chairman of the firm (395a), principal decision-maker, and source of capital, which he gathered when needed from the duPont family in Wilmington. (1813a, 2042a, 2099a)

In early 1970, FID was the third largest brokerage firm on Wall Street (1580a), with approximately 95 offices across the country and in Europe, and approximately 495,000 customer accounts. (394a) Just as the Hirsch firm had been hit by the paperwork crunch of 1968 and the financial crisis which followed in 1969 and early 1970, FID had parallel problems which were magnified by its size. (*id.*)

During the spring of 1969, FID was censured by the Exchange for recordkeeping violations. (1226a-1227a, 482a, 924a) For a while there appeared to be improvement, but this improvement was only temporary. The back office problems of FID reached their worst level in October of 1969, when the Exchange and the SEC began investigation of the firm's operational problems.

This investigation resulted in the Exchange's censuring certain key partners of FID, including Edmond duPont and Wallace Latour. The Exchange also fined each of the censured partners and FID itself a total of $110,000 for improper handling of customer complaints which had resulted from the back office problems. The fines were given wide notoriety in the press on February 6, 1970 (697a, 704a), which followed by one day equally prominent press reports that FID had incurred a $7.7 million loss for the 1969 year. (700a, 702a) These press reports were read by the Hirsch partners. (1870a-1880a) The $110,000 fine was one of the largest ever assessed by the Exchange. (1228a, 1881a) Kohns testified that he had never heard of a fine as large. (1881a)

During an Exchange examiner's visit to FID in the summer of 1969, the examiner detected that FID exceeded

the maximum capital ratio permitted by Rule 325 of 2000% as of June 30, 1969 and July 30, 1969. (492a, 925a, 943a) These violations were promptly corrected by FID through acquisition of additional capital and through research and correction of the paperwork problems which had caused the firm to exceed the permitted ratio. (947a)

Each year pursuant to the rules of the Exchange and the SEC, a member firm was required to have a surprise audit and submit the certified report of the audit to each regulatory body. Haskins & Sells performed such audits for both FID and Hirsch. The Haskins & Sells audit of FID as of September 28, 1969 revealed that FID exceeded the 2000% ratio as of that date. (451a, 515a) Haskins & Sells computed that FID needed to improve its net capital by \$6.8 million to obtain compliance with Rule 325. (452a) Upon receipt of the audit report, the Exchange determined to impose a charge for dividend differences. On that basis the amount of improvement which was required was \$17.3 million. (526a) FID's capital problems and their resolution were discussed at a meeting on December 16, 1969 among FID, Haskins & Sells and Exchange personnel. (567a) It was recognized that the differing views on the amount of FID's capital deficiency were caused by items as to which there was a good deal of uncertainty, both as to FID, and as to the industry as a whole. (1478a-1482a) At this meeting, it was agreed that considerable improvement in FID's capital position could be obtained through research, particularly in the area of customer accounts and long security differences. (*id.*) Robert Bishop, an Exchange Vice President, suggested that FID's unusually large (\$29 million) amount of long security differences might prove a productive area for research because there was a strong likelihood that some of those long differences, upon research, would be found to belong to FID. (1317a-1318a, 1401a, 1456a-1463a, 1506a-1510a, 1581a-1586a)

By the end of 1969, FID was able to report that through such research of various items and liquidation of long security differences found to be proprietary, which effected a \$6 million improvement in net capital (1394a-1395a), FID

had improved its net capital ratio over the $17.3 million required by the Exchange and had regained capital compliance. (524a) Although plaintiffs criticize the research done by FID in the course of liquidating long security differences, the evidence shows that the project was conducted by men of integrity and long experience in the industry, such as Gay and Speicher (1415a, 1503a-1504a), and no evidence was introduced to show that their judgment was not properly exercised. Furthermore, judged by hindsight only an insubstantial number of the liquidated long differences turned out not to be owned by FID. (1425a) At no time during the first eight months of 1970 did FID (or its successor FIDGF) exceed the maximum ratio permitted by the Exchange's Rule 325.

The first round of merger negotiations between Hirsch & Co. and FID. It was in the context of the declining securities market and the specific problems besetting both Hirsch & Co. and FID that the Hirsch partners began to carry forward merger negotiations with FID. In the course of these and all subsequent negotiations with FID, Hirsch & Co. was represented by two firms of competent counsel—Messrs. Guggenheimer & Untermeyer and Messrs. Proskauer, Rose, Goetz & Mendelsohn. (1902a-1903a) By March of 1970, the Hirsch firm appointed Robert Fraiman (a Hirsch partner and a Governor of the Exchange), Mundheim and Kohns as a special committee to investigate and negotiate a merger with FID. (1872a-1874a, 2157a-2160a) This appointment was evidenced by a document signed by the Hirsch partners. (1873a-1874a)

Prior to the commencement of any serious negotiations, the Hirsch negotiating committee, as well as Mr. Hirsch, were well aware of the fact that FID had encountered serious net capital and back office problems. (1969a-1971a, 2164a, 2182a-2183a) As a Governor of the Exchange, Fraiman was involved in the Exchange's consideration and assessment of the various net capital and back office problems of FID, some of which resulted in restrictions, censures and fines being imposed upon the firm and its top

partners. (1597a-1600a) Fraiman relayed such information to his partners. (1878a)

Despite this clear knowledge that the condition of FID was poor, the Hirsch partners, aware that their own firm had lost close to $2.8 million in 1969 (768a) and that the pattern was continuing in 1970 (1844a-1865a, 628a, 640a) and would deplete net capital by year-end (1718a), pressed ahead with the negotiations with FID.

Gariboldi's initial investigation of FID. At about the same time that these initial sessions with FID were occurring, Mundheim called Frank Gariboldi into his office and, in the presence of Kohns, told Gariboldi to check out the condition of FID, a potential merger candidate. (1679a, 1806-1807a) Kohns and Mundheim left entirely to Gariboldi's discretion the details of how to investigate FID. (1687a) Mundheim indicated that he would get from FID any documents that Gariboldi needed to analyze the condition of FID. Gariboldi then listed a number of documents that he needed. These included, among others, the firm's balance sheet, special operations questionnaire, audited questionnaire, and the firm's special financial questionnaire. Mundheim then contacted FID and obtained these documents for Gariboldi. (*id.*) In the course of his investigation, Gariboldi received every document he asked for, and asked for every document he considered necessary and appropriate. (1700a)

After obtaining the various FID documents he believed necessary, Gariboldi developed an analysis sheet and a schedule of questions. (1687a, 1736a-1737a, 721a) After reviewing his analysis and questions with Kohns and Mundheim, Gariboldi asked Gentile, FID's controller, the scheduled questions. (1729a-1731a, 1737a)

Following his discussions with Gentile and others at FID, Gariboldi reported to Kohns and Mundheim all that he had learned about FID. (1679a) He reported that FID's back office was in a mess (2078a), or "bloody mess", as

Kohns understood it to be. (1971a) Gariboldi reported on the existence of FID's large security count differences (1782a), as well as the fact that FID did not charge these differences in their net capital computation, as Hirsch & Co. did and as Gariboldi believed should be done. (1759a) Gariboldi also reported to Kohns and Mundheim on Gentile's disclaimer as to any $20 million standby capital agreement. (1782a) Gariboldi cautioned his principals that they had to watch out that FID's short differences did not get charged against their capital after the merger. (1783a) Haskins & Sells, however, had advised plaintiffs' attorneys that it would be impossible to distinguish between pre- and post-merger short differences. (1290a) Plaintiffs admitted that Gariboldi's analysis was decidedly negative. (1807a, 2077a-2078a) In this conclusion, Gariboldi was supported by Alexander Norman, Hirsch & Co.'s internal auditor and a certified public accountant (1633a) who helped Gariboldi analyze the FID data. (1628a, 1738a-1739a) Norman put it bluntly to Mundheim: "Who needs this merger? Stay away . . . ." (1635a, 1676a, 2028a)

Shortly after Gariboldi had reported the results of his initial investigation to Kohns and Mundheim, the fact of negotiations between Hirsch and FID became known on the Street. (1809a) The negotiations were subsequently called off on April 23, 1970. (1891a-1895a, 699a)

The second round of merger negotiations between Hirsch & Co. and FID. At the time the first series of negotiations with FID was broken off, Hirsch & Co. had incurred an operating loss for the first three months of 1970 of somewhat over $125,000 in total. (1843a-1844a, 638a) This was a great improvement over the 1969 loss rate. (768a) However, in April and May, 1970, the firm incurred a loss of approximately $875,000 for the two months combined (1844a-1845a, 640a) to put the firm on a rate of loss greater than that of the record loss year of 1969. Discussions with FID shortly were initiated again. (1870a) At this time FID raised the possibility of a tripartite merger including Glore. (1898a)

Plaintiffs believed the addition of Glore to be a very positive factor. One partner in Glore, Archie Albright, was thought by Hirsch & Co. to be an excellent back office manager and just the person needed to cope with the recognized back office mess at FID. (1899a) Glore also had an historically strong position in underwriting, which meant that it could be certain of recurring underwriting business from major issuers. (1898a) Other than this common knowledge about Glore, the Hirsch partners knew little else and conducted no investigation of the condition of Glore. (1898a-1899a, 2081a)

There followed a meeting of FID and Hirsch partners at Mundheim's home. Kohns, Hirsch, Mundheim and Fraiman attended the meeting on behalf of the Hirsch firm. Among other things, the benefits that would accrue from the proposed merger were discussed. It was noted that FID had a nationwide network of branch offices and an excellent reputation. It was recognized that Hirsch had good branch offices in New York, Florida and a fine reputation in Europe. (1883a) At this meeting, Kohns asked Edmond duPont whether it was true that FID had a $20,000,000 standby agreement should FID need additional capital. Mr. duPont responded that FID did have such a reserve, that $2.5 million had been used thus far, and that there was $17.5 million available. Kohns then asked if the $17.5 million remaining on call were to be exhausted, did FID have any means of raising additional funds. Mr. duPont then responded, "I can only tell you, Mr. Kohns, that I have never come back from Wilmington empty-handed." (1813a, 1884a) Kohns never pursued this ambiguous statement of Mr. duPont, because to do so "would have made him [duPont] a liar." (1888a-1889a)

Sometimes during the course of the merger discussions, Kohns, Hirsch, Mundheim, Gariboldi, Tom Weil (Hirsch & Co.'s operations partner), and possibly Fraiman spoke with Harold Petrillo, the senior brokerage partner of Haskins & Sells who for years handled both the Hirsch & Co. ac-

count and the FID account. During the course of that conversation, Petrillo opined that the merger would probably be all right if the newly-combined firm could get the proper back office management. (1811a) In that respect, Petrillo said that he thought Hirsch & Co. had something to offer to FID in the way of manpower to correct FID's back office problems. (2119a) When queried about Edmond duPont's statement with respect to his ability to raise additional capital for the merged firm, Petrillo stated his opinion that Mr. duPont's "word is better than his bond." (1969a-1970a)

The later review of FID by Gariboldi and Weil. In June, Kohns asked Weil to check out FID's operations area. (2019a-2020a, 1908a, 2086a) Weil, who was familiar with the FID back office problems, was particularly concerned by the fact that the merger was going ahead, since the last information he had received had been the April 24th statement that no merger was contemplated. (1993a-1994a) At that time, Weil's reaction had been to "stay away". (*id.*)

During June, Weil and Gariboldi examined the most recent special operations questionnaire of FID. (1754a-1755a, 1987a, 602a) This questionnaire revealed that FID had sustained an operating loss of $9.7 million for the first five months of 1970, an amount greater than the $7.7 million loss for the entire 1969 year. Gariboldi also obtained and reviewed the latest FID capital computation, which was as of May 28, 1970. (1756a-1757a, 719a) Gariboldi noted no change in FID's condition since his earlier review in April, except the continuing losses and an additional $1.8 million decrease in net capital from April to June. (1786a-1787a) This fact was reported to the Hirsch partners. (*id.*) Gariboldi also obtained from Kohns "crisis plans" (712a, 717a) which had been prepared by FID and Glore containing suggestions for areas of improvement if more capital were needed quickly to keep the merged firm afloat. (1740a-1743a) Gariboldi told Kohns that he believed the "crisis plans" to be optimistic. (1743a, 1751a)

Weil was particularly concerned about the large value of short security differences that FID was reporting. He was also concerned about other back office problems which appeared to be out of hand such as dividends, transfers and late fails. (2004a-2006a) He knew that FID had had a capital deficiency, was having capital difficulties, and needed more capital. (1999a-2009a) Weil determined that all of these items were serious problems, and he so indicated to various partners of the Hirsch firm, including Kohns and Mundheim. (*id.*) As a result of his review, Weil formed the opinion that FID was in a sad state of affairs and so reported to Kohns and Mundheim. (1997a, 2000a-20[illegible]) Weil told Kohns that he would not go along with the merger because he believed FID was very sadly lacking in proper control. (1998a-1999a) Weil also pointed out that FID's short security differences could cause a drain on capital because those differences that could not be researched away would have to be bought in. (2006a-2007a) Weil knew from his prior experience that Mundheim and Kohns well understood what he had told them. (2006a-2007a)

Plaintiffs testified at trial that they had been unaware that the Haskins & Sells audit as of September 28, 1969 had shown FID to be in violation of Rule 325 or to have certain material inadequacies in its recordkeeping system.[6] (1816a-1818a, 2037a-2040a, 2142a-2145a) However, it became plain that the availability of the audit report which did show such information was known to plaintiffs and their employees and fellow partners who participated in the investigation of FID, but these reports were not pursued because the information was judged to be stale and therefore immaterial. (1962a-1964a) Gariboldi had noted the decline in FID's long securities differences from $29 million to $10 million from November, 1969 to January 30, 1970 (1706a), but had

6. Although Mr. Hirsch did testify that he knew FID had been in capital violation and had corrected the violation prior to the merger. (2164a)

not believed that decline to be material. As Gariboldi put it: "My concern was basically the current financial position of duPont, not what happened six months ago." (1691a, see also 1709a) Gariboldi testified that had he wished, he could have made his own capital computation as of September 28, 1969 from the data which he had been furnished (1710a-1711a), and that he knew a material inadequacies report as of September 28, 1969 would have been a product of the audit, but did not ask to see it. (1713a-1714a)

The Merger. On July 2, 1970, the merger agreement was signed. (321a) A significant number of Hirsch partners opted not to join the merger firm. (1936a) Among the opt-outs was Tom Weil. (321a) Gariboldi did not join the merged firm either. (2080a) The agreement provided for an assumption of all liabilities of Hirsch & Co. by FID; the prior acquisition of Glore by FID; a contribution of at least $4 million in capital by the Hirsch partners; exculpation of the Hirsch partners from any losses incurred by FID prior to July 2; special compensation and benefits to Kohns and Mundheim in the form of salaries of $36,000 per year while active and thereafter $25,000 per year for life in retirement benefits; the same retirement benefits for Mr. Hirsch; the right of those three men to a total of 2.5% of the profit of the merged firm; and the right by the Hirsch partners to withdraw their entire investment less any losses attributable from operations after July 2, 1970, which right could be exercised on December 31, 1970 provided notice had been given not later than December 21, 1970. (321a)

From the amended complaint and the course of the trial, it appeared that plaintiffs' theory was that FID deceived the Hirsch partners to lure Hirsch capital into FIDGF. However, the evidence contradicts that theory. FID assumed all the Hirsch assets and liabilities, but not all of the Hirsch capital, since some Hirsch partners, such as Tom Weil and Maurice Meyer, did not join FIDGF. As a result, the contributed Hirsch capital of $4.4 million was not nearly sufficient to support the capital charges contributed by Hirsch to FIDGF, and FIDGF took on a capital

charge from Hirsch & Co. rather than a capital increment. (1787a)

The Exchange had no communication with plaintiffs. At no time during the course of negotiations leading up to the merger did plaintiffs have any communication with any officer or employee of the Exchange with respect to the merger. (1937a, 2087a, 2175a) The concept of the proposed merger was communicated by defendant Latour on behalf of FID to Lee D. Arning, a senior vice president and the responsible officer of the Exchange. The Exchange had no requirement for its approval of a merger of its member firms. (1495a-1497a, 1546a) The only authority which the Exchange had was to satisfy itself that after the merger, the merged firm would comply with Exchange rules. (1495a-1497a) Arning judged that it would, and that the merger offered a good basis for a successful operation (1530a-1531a) which stood a chance of improving the sorry profitability of each of the ingredient firms and attracting additional needed capital. (1531a-1532a) He judged that any attempt on the part of the Exchange to prevent the merger would have been arbitrary. (1546a) The factors that the Exchange judged to favor merger were: vast combined savings; a compatible mix of business contributed by the three firms; a strengthened combined management team; and potentially greater profitability. (1540a-1541a)

Plaintiff's representations to the Exchange. After the transaction was closed, all Hirsch partners who joined the merged firm had to be approved as such by the Exchange. (706a) Hirsch, Kohns and Mundheim thus applied to the Exchange for approval as partners in FIDGF. (631a, 618a, 623a)

On their signed applications and agreements submitted to the Exchange (613a, 618a, 623a) in a big box headed "IMPORTANT", all plaintiffs stated that they had made such investigation of FID that they felt necessary and appropriate and that their investigation included an examination of the firm's latest certified audit and a recent computation of net capital. Each plaintiff admitted that he

was not relying on the fact that FID was a member firm of the Exchange or upon the Exchange's surveillance of FID or its capital position. Finally, each plaintiff in his application represented to the Exchange that he was not relying on the Exchange to provide any information concerning or relating to FID and agreed that the Exchange had no responsibility to disclose any information concerning or pertaining to FID. (*id.*) Each plaintiff testified at the trial that those representations to the Exchange were truthful and accurate. (1950a, 2127a-2129a, 2179a)

Plaintiff's early discovery of the alleged fraud and their failure to act. Following the merger on July 2, Kohns and Mundheim were elected to the Finance Committee of FIDGF (1953a, 2097a), which was the most important decision-making committee in the firm. (2099a) If there were any doubt in plaintiffs' minds about the condition of the merged firm's capital, it should have been dispelled within the first few weeks following the merger. On July 10, 1970, the Finance Committee of FIDGF received a letter from Fred J. Stock, Jr., an assistant vice president of the Exchange, which indicated that the excess net capital of the merged firm was thin and that any substantial operating losses would endanger the new firm's ability to comply with Rule 325. (611a)

Not only was the capital position of FIDGF thin, but its operational condition needed improvement. Petrillo had cautioned that he thought the proposed merger would probably be all right if proper back office management could be found. (1811a) Plaintiffs had counted on Archie Albright, from Glore, to fill this recognized management need. (1899a) However, Albright never became active in FIDGF, leaving the crucial management gap unfilled. (1900a)

Shortly after the merger, Kohns, Mundheim and Hirsch discussed among themselves the poor financial and operational condition of the merged firm and came to the belief that they had been "misled" with respect to their invest-

ment. (2094a, 2179a-2180a) Mundheim also had a similar discussion with Russell Forgan, who had come from Glore and who believed that he too had been "misled." (2094a) Plaintiffs, however, took no action nor made any complaint to anyone. Rather, Mundheim solicited his wife and daughter to subordinate their funds to bolster the net capital position of FIDGF. (2095a-2096a)

In November, the Haskins & Sells audit of FIDGF as of September 27, 1970 showed the firm's net capital position to be so strained that the Exchange required the firm to liquidate $10 million worth of its proprietary securities to bolster the firm's net capital position. (420a, 534a, 535a) This report confirmed what plaintiffs knew already—that FIDGF was suffering heavy losses in the second half of 1970 and was in a precarious net capital position.

Plaintiffs make a new investment despite the alleged fraud and full knowledge of the condition of FIDGF. On December 3, 1970, Hirsch, Mundheim and Kohns advised the Executive Committee and the Finance Committee of FIDGF that pursuant to the merger agreement of July 2, 1970, they wished to withdraw from the firm completely, effective December 31, 1970, taking their capital with them. (1819a-1820a, 2043a-2044a, 2146a, 904a, 906a) Following these notices, plaintiffs and their attorneys met with various of their FIDGF partners and an officer and two Governors of the Exchange. (2044a-2056a) As a result of these meetings, the three plaintiffs reversed their position, deciding to reinvest their capital in FIDGF in a different form and on more attractive terms. (656a) No wrong is alleged to have been worked on plaintiffs by anyone in connection with their December investments.

On December 14, 1970, a new agreement was signed between FIDGF and Hirsch, Kohns and Mundheim. (656a) This agreement modified the July 2 agreement by allowing the three individuals to maintain their investment in the merged firm in the form of subordinated loans (to which operating losses were not attributable) to be repaid on dates

certain in the future. (*id.*) Under this agreement, Mundheim withdrew $225,000 of his capital immediately. Subsequently Hirsch withdrew $100,000 and Kohns withdrew $225,000. The remainder of the investment of each plaintiff was consumed in support of the business of FIDGF.

Despite the decision by Kohns, Mundheim and Hirsch to maintain their investment in FIDGF, a number of other former Hirsch & Co. partners who had joined the merged entity gave notice of their retirement and did retire on December 31, withdrawing their capital from FIDGF. (1959a-1960a, 2138a)

Summary of the Argument

Plaintiffs' argument on this appeal assumes that this Court should make findings of fact different from those of the trial court. Yet plaintiffs make no significant attempt to overcome the basic rule that a court of appeals must accept the findings of fact of the trial court unless they are shown to be "clearly erroneous." This rule is especially applicable in a case such as this where the key issues are what was told to whom, by whom, when, what it meant, and what was the motive of the parties and the witnesses.

Plaintiffs' claim against the Exchange must lie, if at all, on the Exchange's omission to disclose whatever knowledge it had about FID absent having been asked to do so and absent any fact to excite the Exchange's suspicion that plaintiffs were not otherwise obtaining full disclosure. However, as the trial court noted (Op. 13, 92a), there was no evidence on which there could be based any obligation on the part of the Exchange to volunteer to plaintiffs any information about FID. The Exchange knew that the partners of FID and the partners of Hirsch & Co. were experienced professional securities executives who were knowledgeable and well advised both in respect to the questions to ask of a potential merger candidate, and conversely, in respect to their own obligations to disclose to that potential merger candidate material facts about their own firm. Both firms were active participants in underwritings, and they and their counsel faced disclosure questions every day. The result of recognizing plaintiffs' claim would have been to compel the

Exchange, as a volunteer, to take over the disclosure function, and attendant risk, for all member firms wherever the Exchange has some knowledge material to a transaction. There is no rationale by which such a duty could be confined to mergers between member firms.

The trial court found that there was no evidence to suggest that the Exchange was not completely justified in concluding that each side had the requisite capability and integrity both to inform itself and to disclose about itself.

> "On the basis of this record, there is little doubt that NYSE was fully entitled to conclude that plaintiffs had fully informed themselves concerning all the facts relating to FID and had decided to go forward with the merger, fully advised of all the facts." (Op. 14, 93a)

ARGUMENT

I

The Trial Court's Findings are Supported by Substantial Evidence

The limitations imposed on an appellate court by Rule 52(a) of the Federal Rules of Civil Procedure were expressed by the Supreme Court in *Zenith Radio Corp.* v. *Hazeltine Research, Inc.,* 395 U.S. 100, 123 (1969), as follows

> "In applying the clearly erroneous standard to the findings of a district court sitting without a jury, appellate courts must constantly have in mind that their function is not to decide factual issues *de novo.* The authority of an appellate court, when reviewing the findings of a judge as well as those of a jury, is circumscribed by the deference it must give to decisions of the trier of the fact, who is usually in a superior position to appraise and weigh the evidence. The question for the appellate court under Rule 52(a) is not whether it would have made the findings the trial court did, but whether 'on the entire evidence [it] is left with the definite and firm conviction that a mistake has been committed.' *United States* v. *United States Gypsum Co.,* 333 U.S. 364, 395 (1948)."

Accord: Langford v. *Chrysler Motors Corp.,* 513 F.2d 1121, 1127 (2d Cir. 1975) ("unless clearly erroneous, the evaluation of the credibility of witnesses and the weight of evidence is the responsibility of the trial judge"); *Allen & Co.* v. *Occidental Petroleum Corp.,* 519 F.2d 788 (2d Cir. 1975); *J. Howard Smith, Inc.* v. *S. S. Maranon,* 501 F.2d 1275 (2d Cir. 1974) (it is the proper province of the trial court to resolve any conflicts in the evidence).

The facts found by the trial court are set forth above and the record references are cited for the supporting evidence. Plaintiffs' brief in large part ignores such evidence. They mistakenly assume that all testimony and permissible inferences supporting their case should have been accepted by the trier of the facts and everything else rejected. They do not claim that the evidence supporting each finding is insubstantial or inadmissible. They apparently would prefer to believe that it simply does not exist.

Plaintiffs have attacked the trial court's decision in two principal areas. They argue that 1) the failure of the Exchange to disclose to plaintiffs certain information about the condition of FID in 1969, over six months prior to the merger, violated some obligation or duty that the Exchange had to plaintiffs, and 2) the suggestion of the Exchange to FID on December 16, 1969 to liquidate long security differences after research was "an illegal way of raising capital", which somehow redounded to plaintiffs' detriment. (Br.[7] 32-33) With respect to the first area, the trial court found that the "NYSE was fully entitled to conclude that plaintiffs had fully informed themselves concerning all of the facts relating to FID and had decided to go forward with the merger, fully advised of all of the facts." (Op. 14, 93a) The trial court found that the action of plaintiffs and their representatives, Gariboldi and Weil, during the negotiations leading up to the merger "belie any contention that FID's condition in 1969 would have been or might have been material to plaintiffs' decision to join forces with

7. "Br." refers to the designated pages of appellants' brief.

FID in July, 1970, or that they placed any reliance on any supposed understanding of FID's 1969 status based upon any misrepresentation to or concealment from them by NYSE in making the decision to go forward with the merger plan." (Op. 16, 95a)

The trial court correctly noted that neither plaintiffs nor their representatives sought any 1969 data although it was clearly available to them and they were aware of its existence. It is also undisputed, as the trial court points out, that plaintiffs' did have information with respect to the Exchange's censures and fines of FID in 1969 and 1970; that plaintiffs were aware of FID's serious back office problems throughout this period; and that Fraiman, one of the plaintiffs' partners, a member of the Hirsch & Co. negotiating team, and a member of the Board of Governors of the Exchange, kept plaintiffs up to date with what he learned as a member of the Exchange Board, and was in a position to obtain 1969 data if such data was to be a basis for plaintiffs' decision. (Op. 17-18, 96a-97a)

The trial court's findings are supported by a mass of testimony showing that from the Gariboldi and Weil investigations and from knowledge directly acquired by the members of the Hirsch negotiating committee, plaintiffs had full knowledge of the poor condition of FID. The record shows that plaintiffs knew that: FID was losing money at an ever-increasing rate; FID had been in violation of the Exchange's net capital rule but had corrected the violation prior to the commencement of the merger discussions; FID was continually struggling to meet the Exchange's minimum net capital requirements; FID's back office was a "bloody mess"; and FID desperately needed capable back office leadership. (pp. 8-16, *supra*)

Plaintiffs themselves admitted that on the basis of the knowledge which they had, they were reluctant to proceed with the merger. Kohns testified that he was "very stupid" in proceeding with the merger absent resolution of the problems raised by Gariboldi's investigation. (1913a-1914a) Mr. Hirsch testified that he "acquiesced" in the merger but believed that "there were better opportunities" elsewhere. (2172a-2173a)

At trial and in their brief on appeal (Br. 14-15), the only facts that plaintiffs contend (1816a-1818a, 2037a-2040a, 2153a) they were unaware of are matters of historical detail and immaterial. Plaintiffs testified that they entered the merger unaware of the capital ratios calculated either by Haskins & Sells or the Exchange for FID as of September 28, 1969. Similarly, plaintiffs complain that they were not shown Haskins & Sells' material inadequacies letter for FID as of September 28, 1969. Most significantly, plaintiffs do not and cannot deny that at the time they invested they knew FID had both serious capital and back office problems. Furthermore, plaintiffs knew that an audit of any member firm in 1969 generated a memorandum of capital computation and a material inadequacies letter. Yet, no request was made for this information in the spring or early summer of 1970 because, as Gariboldi put it, "[m]y concern basically was the current financial position of duPont, not what happened six months ago." (1691a) Thus, Gariboldi, plaintiffs' own expert, classified as immaterial the data that plaintiffs claim was withheld. Plaintiffs' further contention that FID's capital deficiency was chronic, having existed for the last six months of 1969, is equally immaterial for the same reasons, and is not supported by the record. (947a)

Plaintiffs' other major challenge to the trial court's findings relates to the December 16, 1969 suggestion by Bishop that FID liquidate researched long security differences. The trial court rejected plaintiffs' contention that FID's liquidation of roughly $6 million of its long security differences was improper, illegal or had an impact on plaintiffs' investment. (Op. 16-19, 95a-98a)

In order to overcome the trial court's finding, plaintiffs struggle mightily to construct a scenario which portrays Bishop directing FID to dash out and sell securities in long difference accounts and claim credit for the proceeds without sufficient research to justify the credit. However, the evidence shows that FID's liquidation of long security differences was a common and proper method of raising capital, which, most important of all, worked.

The evidence is overwhelming that Bishop suggested that FID research long security differences and that FID did, relying in good part on research that had been started but not completed when Haskins & Sells signed off on their audit on November 26. Of the $6 million of securities researched and then sold from a total of $29 million in the long difference account, only an insubstantial number proved to be questionable. (1424a-1425a)

In attempting to build their argument of the illegality of Bishop's suggestion and the subsequent liquidation by FID, plaintiffs selectively quote (Br. 18-19) from Lill's memorandum of the December 16, 1969 meeting (567a),[8] from Gay's testimony about what he understood Bishop to have meant (Br. 20), and from a letter by Latour, an FID partner who was not present at the December 16 meeting. (Br. 21) Obviously, the first place plaintiffs should have started was with what Bishop testified that he said at the December 16 meeting. Bishop said:

> "So I explored that item [long differences] for a little while. I had been dealing with differences on an intensive basis for a year and a half and for five years on a less frequent basis, and I was familiar with the fact that differences were common, stock record differences I am talking about, in those days and in numbers of that size, but it was not too usual to have such a large disparity between long differences and short differences. And this excited my curiosity and led to some questions, and I was told that although the firm had put a great deal of work on their short differences I suppose knowing that there was the possibility of our making a decision to charge some or all of the short differences, but we never charged long differences. So

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8. Plaintiffs do not quote the portion of Lill's memorandum which shows that Haskins & Sells agreed with Bishop's suggestion that FID research and liquidate, if possible, long security differences to improve net capital. Page 4 of Exhibit 226, in part, reads: "H&S then agreed with Mr. Bishop's conclusion. . . ." (570a)

that they had put a lot of work on their long [*sic*: short] differences but Mr. Speicher said they hadn't done much work on the long differences.

"Now, I also knew from my previous experience that when you start—that differences ordinarily come in sort of a distribution curve just like fund raising.

"You get some of your gifts from—you get half of your money from very large gifts and it's the same way in—stock record differences usually. There are some stocks that have very large differences and then a whole lot of them have small differences.

"So that it was usually productive in an initial approach to differences to research the large ones. You take the ones over a million dollars first and then those over a half million and so forth.

"So I said, well, for heaven's sakes, since there is the possibility that some of these long differences belong to the firm why don't you get busy and work on those long differences instead of just working on the shorts and see if you can't release some of them as capital. And that's what they went home to do.

"Q Was it your understanding of what you said that they should research them so that they could find the resolution of the difference to an identifiable solution?

"A I understood that in most instances they would do that. In some instances they might determine that the firm owned the securities through exhausting the other possibilities.

"Q That is to say examining all of the other possibilities of claim against the security and finding that no evidence existed in the records of such a claim.

"A Might not be only claims. I don't know what they would do in detail.

"Q I just mean in the largest sense. About where it belongs someplace.

"A Yes.

"Q So that in your authorization there were two ways they could do it. One if they resolved it on an identified resolution basis to a transaction or to a specific account or to some proprietary account which indicated a specific identity of the error relating to the difference, or, secondly, if they went through their records and could find no basis for allocating the security to a customer or broker. [colloquy]

"Q Mr. Bishop, do you remember what you said?

"A My best recollection of what I said was, wouldn't it be a good idea to work on these long differences? I don't believe that I specified either way of the two that you have just been discussing, and I don't believe that I authorized anything. *I pointed out to the firm what was a standard technique that many other firms had been telling me they were doing,* and that duPont had been heavily engaged in as far as their short differences were concerned.

"I was merely pointing out to them that how could they let $26 [*sic*: $29] million worth of long differences stand unworked on when they had been putting so much effort into the short differences." (1582a-1586a) (emphasis added)

All witnesses who attended the December 16 meeting agreed that Bishop's suggestion was that such research as was necessary should precede liquidation of any long security differences before being claimed as capital of FID. Lill testified:

"Mr. Bishop never implied that they should be liquidated without research.

* * *

"they had progressed to some extent with the longs and the essence of Mr. Bishop's suggestion, as I recall it, was that, well why don't you start to concentrate more on the longs so that you can learn enough about them and put you in a position to liquidate." (1318a)

Mr. Speicher testified:

"MR. GILLESPIE: The question is, your Honor, did you understand from Mr. Bishop at the December 16 meeting that it would be all right to sell the long securities only if you found them to be owned by you?

"THE COURT: The objection is overruled.

"A He said with research. That's the words he used." (1401a)

Mr. Chenet testified:

"THE WITNESS: As I recall at this meeting the instruction would have come from Mr. Bishop, only he had the authority. And the instruction was to research the long security differences and to sell those that the firm felt that they couldn't sell—that they could sell. That is those that they determined were not due to customers or other brokers and appeared to be proprietary, or firm securities. (1456a)

Mr. Gay testified:

"During the conversation, Mr. Bishop brought up the fact that if we had long stock record differences, or security count differences, excuse me, and they are legitimate or bona fide long differences, then we should consider selling some of these differences out.

"Q Can you tell me what you understood him to mean by legitimate long differences?

"A I considered that Mr. Bishop indicated or meant by his indication that the firm would do research and would do that which is necessary to establish whether a long count difference is truly a long difference and therefore can be sold out." (1506a-1507a)

It is clear from the testimony that the Exchange's suggestion to research long differences as a potential source of net capital improvement left to FID personnel in their professional judgment the question of what research was necessary and what securities, if any, should be sold. Plain-

tiffs' contention (Br. 23) that FID's recordkeeping inadequacies precluded accurate research begs the question. Firms without recordkeeping problems do not have security count differences. (*See generally*, 1306a-1310a) Such differences are a *per se* indication of recordkeeping problems. The obvious way to cure both recordkeeping problems and differences is by research.

Plaintiffs argue (Br. 33) that the research must have been inadequate because it was conducted "immediately", *i.e.*, between the December 16 meeting and December 24, when Gay indicated to Chenet that FID had brought itself into capital compliance. (524a) This argument is misleading because it overlooks the fact that a good deal of research on which FID could rely had been accomplished, although not completed, during the audit. After the auditors left on November 26, FID personnel continued their work on these differences. Lill testified:

> "Q Do you know whether the research by the duPont personnel continued on after November 26th?
>
> "A There was a group in place that did continue, yes, sir.
>
> "Q When you signed off on November 26th did you know whether there were differences which were reported in your report as to which research had been done but not yet completed?
>
> "A Yes. There are various stages of completion. The research of one item may go over a period of six or eight weeks before it is ultimately resolved. So at any given date on any given difference there are varying degrees of progress.
>
> "Q And when you signed off on November 26th can you tell us the approximate number of differences as to which there had been some research completed but not yet enough for you to withdraw them from your report as differences? [colloquy]
>
> "A Well, as to numbers of differences there were thousands. Something between four and 6,000, as I

> recall, that were still open that were in various stages of progress. Some very little, others almost complete. I could not fix an effective completion of what the difference was." (1314a-1315a)

Indeed, Speicher testified that prior to December 16 research had been completed on some, and maybe all, of the long differences which were liquidated between December 16 and December 24. (1405a) In any event, it is not at all startling that between November 26 and December 24, $6 million worth of long differences were resolved by additional research which built on that research accomplished prior to November 26. All FID financial statements thereafter included the results of the sale, and Gariboldi noted the dramatic decrease in long differences. The trial court found:

> "Plaintiffs received whatever they asked for, and none of the evidence supplied was false or misleading or tended to give plaintiffs a false picture of duPont's financial status." (1095a)

Plaintiffs complain (Br. 26) that the Exchange took no step during the first six months of 1970 to verify how FID brought itself into capital compliance on December 24, 1969. There was, however, no reason for the Exchange to require any more detail from FID than the normal reporting which was required of all firms. As Bishop testified (1585a-1586a, quoted *supra* at p. 27), the research and liquidation of differences to improve net capital was a common technique for firms during the period of the paperwork crunch. As of January 30, 1970, FID submitted a special financial questionnaire (908a) which showed essentially the same categories of information as the Haskins & Sells regular audit report as of September 28, 1969. (410a) Throughout the spring of 1970, FID was submitting detailed special operations questionnaires on a monthly basis (*e.g.*, 593a, 915a) and written capital computations on a weekly basis. (1410a) There was no reason for further verification.

When it is considered that FID had $29 million in long differences, it is not so surprising that FID was able

properly to research and liquidate $6 million, a rate of resolution of approximately 20%. Indeed, plaintiffs' whole argument is based on the assumption that the $6 million improvement in FID's net capital gained by research and liquidation of long security differences was not good capital. But Speicher, who was active in the liquidation program at the time and who continued as the liquidator of FID (1390a), testified that no appreciable or substantial number of long security differences liquidated in December 1969, turned out not to belong to FID. (1424a-1425a)

Plaintiffs' argument that the liquidation "was an illegal way of raising capital" (Br. 23) is a conclusion without evidentiary foundation.

II

The Exchange Has No Liability to Plaintiffs Based on Alleged Statements or Omissions Made by Others Without the Knowledge of the Exchange

A. The Exchange had no duty to disclose

The trial court found that "there is nothing in the record to indicate that the NYSE participated in any way (advised encouraged or brought the parties together) in the merger negotiations." (Op. 12, 91a) Plaintiffs have been unable to point to any evidence in the record to the contrary. As a non-participant in the purchase and sale transactions, the Exchange had no duty to disclose information about FID to plaintiffs. Accordingly, the Exchange cannot be held liable under Rule 10b-5. *Hochfelder* v. *Midwest Stock Exchange,* 350 F.Supp. 1122 (N.D Ill. 1972), *aff'd,* 503 F.2d 364 (7th Cir.), *cert. denied,* 419 U.S. 875 (1974); *Wessel* v. *Buhler,* 437 F.2d 279 (9th Cir. 1971).

In *Wessel,* the court said:

> "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction. On the contrary, the only subsection that has any reference to an omission, as distinguished from

affirmative action, is subsection (2) providing that it is unlawful 'to omit to state a material fact necessary in order to make the statements made . . . not misleading,' i.e., an omission occurring as part of an affirmative statement. (*See* Brennan v. Midwestern United Life Insurance Co. (7th Cir. 1969) 417 F.2d 147, 154-155.) We perceive no reason, consonant with the congressional purpose of enacting the Securities and Exchange Act of 1934, thus to expand Rule 10b-5 liability. (*Cf.* SEC v. Texas Gulf Sulphur Co., supra, 401 F.2d at 866-868 (J. Friendly, concurring specially).) On the contrary, the exposure of independent accountants and others to such vistas of liability, limited only by the ingenuity of investors and their counsel, would lead to serious mischief." (437 F.2d at 283)

This principle has been confirmed by the *en banc* decision of this Court in *Lanza* v. *Drexel & Co.,* 479 F.2d 1277 (2d Cir. 1973). The Court in *Lanza* cited *Wessel* v. *Buhler* and concluded:

> "We recognize that participation by a director in the dissemination of false information reasonably calculated to influence the investing public may subject such a director to liability under the Rule. But it is quite a different matter to hold a director liable in damages for failing to insure that all material, adverse information is conveyed to prospective purchasers of the company's stock absent substantial participation in the concealment or knowledge of it. Absent knowledge or substantial participation we have refused to impose such affirmative duties of disclosure upon Rule 10b-5 defendants." (479 F.2d at 1302)

If a director has no duty "to insure that all material, adverse information is conveyed" by those who are privy to the transactions, clearly the Exchange, a party even more remote from plaintiffs' transactions, can have no such duty. The Exchange cannot be held to presume fraud by its members when they deal with one another. FID was a respected member firm which dealt with disclosure issues constantly

in the course of its underwriting and investment advisory business. Obviously, the Exchange had no duty to monitor every discussion concerning merger with or investment in FID or to know the content of every statement made by FID to plaintiffs. Indeed, such a proposition would be absurd! Yet, that is what plaintiffs' disclosure claims against the Exchange came down to.

Plaintiffs claim that FID's net capital violations in 1969 were illegal under Section 8(b) of the Exchange Act (Br. 37-40) and that, presumably, such illegality affected the Exchange's duty of disclosure. At no time before this appeal have plaintiffs raised the applicability of Section 8(b). Plaintiffs therefore are barred on this appeal from challenging the trial court's determination on the basis of Section 8(b). *Hormel* v. *Helvering,* 312 U.S. 552, 556 (1941); *National Equipment Rental, Ltd.* v. *Stanley,* 283 F.2d 600 (2d Cir. 1960); *Capps v. Humble Oil & Refining Co.,* 536 F.2d 80 (5th Cir. 1976); *Browzin* v. *Catholic University of America,* 527 F.2d 843 (D.C. Cir. 1975)

Had plaintiffs raised the issue of Section 8(b) before, it quickly would have become apparent that Section 8(b) does not apply. Section 8(b), which was repealed by Section 5(2) of the Securities Acts Amendments of 1975, Pub.L.No. 94-29, 89 Stat. 97 (June 4, 1975), was as its title shows, a restriction on borrowing, not a measure of the financial responsibility of a broker-dealer. Compare Section 15(c)(3), 15 U.S.C. § 78o(c)(3), discussed *infra.* Section 8(b) restricted only the borrowings incurred in a member's business "as a broker" to an amount that did not exceed 2,000 percent of his net capital "employed in the business." Compare Section 8(a), which restricted borrowings in the ordinary course of business "as a broker or dealer." Shortly after enactment, it became clear that it was extremely difficult to sort out a firm's brokerage business from its business as a dealer or underwriter or investment advisor so as to meet the strictures of Section 8(b). The SEC, in fact, never prescribed any rules or regulations under Section 8(b). The SEC, rather, sought amendment of Section 15(c)(3).

Loss has described the early demise of Section 8(b) as follows:

> "And even as to those broker-dealers who are covered, the section applies only to indebtedness incurred in the normal course of their brokerage business; apart from the difficulty of segregating a broker-dealer's indebtedness incurred in the course of his brokerage business from that incurred in his business as a dealer, the section is inadequate in failing to recognize that the obligations of a broker outside of his business frequently subject customers to the same types of risks as obligations incurred in his securities business, whether as a broker or as a dealer. Although the twenty-to-one ratio of § 8(b) was early applied [pre-1943] in a few clear cases of insolvency on the theory that the section is self-executing, these difficulties have discouraged the Commission from implementing the section by rule.
>
> "Instead the Commission has acted under § 15(c)(3), a more general provision added in 1938 to prohibit *any* broker or dealer from using the mails or interstate facilities to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances or commercial bills) otherwise than on a national securities exchange 'in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers.' " II Loss, *Securities Regulation,* pp. 1350-1351 (1961)

Under its Rule 15(c)(3), 17 C.F.R. 240.15c3 (1969), the SEC prescribed a net capital rule prohibiting aggregate indebtedness from exceeding 2,000 percent of a broker-dealer's net capital, but exempted from the operation of its rule members of those national securities exchanges which, in the SEC's judgment, had more comprehensive capital rules. The Exchange was specifically named as such

an exchange. See SEC Rule 15c3-1(b)(2), 17 C.F.R. § 240.15c 3-1(b)(2) (1969). Unlike Section 8(b), the SEC's rule applied to the aggregate indebtedness and net capital of a broker-dealer arising from all aspects of its business. II Loss, *Securities Regulation,* pp. 1353-1355 (1961). The Exchange's net capital rule similarly applies to the entire aggregate indebtedness and net capital of a member firm such as FID. "Aggregate indebtedness" is defined to mean "total money liabilities." Rule 325(b)(2), 2 CCH NYSE Guide ¶ 2325 at 3525 (1970). "Net capital" is defined to mean "Net Worth" with certain adjustments to reflect liquidity. Rule 325(b)(4), *id.*

All evidence in the record of FID's net capital ratio are computations made under Rule 325. The Rule 325 computations are entirely different from a computation that would be made under Section 8(b)[9]. If plaintiffs now seek to contend that FID violated Section 8(b) of the Exchange Act, they have put in no evidence to show what FID's computation would be under Section 8(b).

Plaintiffs' attempt to impose liability on the Exchange for failure to disclose must also fail because there is no evidence to show that the Exchange acted with the "guilty knowledge" or "scienter" required by *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976); *Cohen* v. *Franchard Corp.,* 478 F.2d 115, 123 (2d Cir.), *cert. denied,* 414 U.S. 857 (1973); and *Lanza* v. *Drexel & Co., supra.*

Nor did plaintiffs exercise the due care required by such cases as *City National Bank of Fort Smith, Ark* v.

9. One simple illustration of a difference is that Section 8(b) talks of "net capital (exclusive of fixed assets and value of Exchange membership) employed in the business [as a broker]." FID enjoyed a broad spectrum of business: retail broker, rights dealer, underwriter, and investment advisor. Therefore, the Exchange's computation under Rule 325 would look to the aggregate indebtedness and net capital of FID for all its sources of business. Section 8(b) would look only to FID's business as a broker. Another difference would be that net capital under Section 8(b) would include securities owned by FID, either at market value or at cost, assuming that the section leaves to ordinary accounting principles the valuation of securities. The Exchange's Rule 325 "haircutted" by 30 percent the market value of securities. See Rule 325(b)(4)(B), 2 CCH NYSE Guide ¶ 2325 (1970).

Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied,* 399 U.S. 905 (1970) and *Rochez Bros., Inc.* v. *Rhoades,* 491 F.2d 402, 409 (3d Cir. 1974), *cert. denied,* ____ U.S. ____ (1976). The trial court found that plaintiffs "could have and would have" secured the information they now claim was not disclosed to them if they had considered it of consequence:

> "They thus must fail on another ground since they did not exercise the due care which can be reasonably expected of sophisticated businessmen of plaintiffs' calibre. They did not consider any 1969 data important at the time and no reason exists to allow them to breathe materiality and reliance into such information now." (citations omitted) (Op. 18, 97a)

Plaintiffs knew that a memorandum of net capital computation and a material inadequacies letter were the products of an audit, but failed to request these documents—documents on which they now base their claim. Gariboldi knew of the dramatic drop in FID's long securities differences, but failed to inquire further. Plaintiffs knew that the Exchange was a repository of information about any one of its member firms, but they failed to request any information from the Exchange about FID. Finally, plaintiffs failed to make any investigation at all about Glore—an integral portion of the brokerage firm in which they were investing.

The reason why plaintiffs failed to exercise due care commensurate with their business sophistication and expertise, as the trial court found, was that they "wanted this merger to go forward." (Op. 19, 98a) Motivated by a desire to avoid further losses and liability as the principal partners in Hirsch & Co. and to secure their retirement, plaintiffs "overestimated Edmond duPont's ability to secure sufficient financial help . . ." and "under estimated the evident weakness of FID, which Gariboldi and Weil had pointed out to them." (Op. 19, 98a)

The conduct of plaintiffs in this action bears many similarities to that of the plaintiffs in *Titan Group, Inc.* v. *Faggen,* 513 F.2d 234 (2d Cir. 1974), *cert. denied,* 423 U.S. 840 (1975). In that action, this Court affirmed the finding of the trial court that Titan had not relied on any alleged

misrepresentations regarding adjustments to earnings, analysis of clientele, and computer capacity in data provided to it by Faggen:

> "The inducement for the contract, the judge found, lay elsewhere . . . . He found that these broad considerations, rather than interstitial details of client lists or of immediate data processing capacity, sparked Titan's acquisitive interest. As to the adjusted earnings statements, the trial judge found that Titan was aware of the basis of the adjustments; and was aware, or should have been aware, from the tax return that the bottom line figures included, rather than excluded, investment income. He found that Titan was interested during the preliminary discussions with Faggen, and subsequently, in the financial analysis of his companies in but rough "ballpark" figures. . . ." (513 F.2d at 238)

In a case such as this, where there are alleged misrepresentations and alleged omissions, and where there is an abundance of evidence that the claimants considered certain facts to be important (the losses and contingent liabilities of Hirsch & Co.), and not other facts which other persons in other circumstances might consider important (past capital ratios and an outdated material inadequacies letter), the claimants cannot be heard to contend, with the benefit of hindsight, that the facts which were not important to them were "material". *Titan Group, Inc.* v. *Faggen, supra,* 513 F.2d at 239.

B. The Exchange has no liability for aiding and abetting

The trial court properly found that the Exchange did not participate in any way in the merger negotiations and that the Exchange was fully entitled to conclude that plaintiffs were fully advised of all the facts before going forward with the merger. (Op. 12, 91a; Op. 14, 93a)

In *Wessel* v. *Buhler, supra,* the Court of Appeals for the Ninth Circuit held that where a defendant was not a party to the transaction itself and where its conduct consisted solely of inaction, it cannot be liable to the plaintiff as an aider and abettor under Rule 10b-5. Any holding to the contrary would be anomalous, since a more stringent legal

duty would be imposed upon an aider and abettor than upon a principal. The Court of Appeals for the Seventh Circuit in *Hochfelder* v. *Midwest Stock Exchange, supra,* relied on the decision in *Wessel* v. *Buhler* and held that the Midwest Stock Exchange could not be liable on an aiding and abetting theory, stating that

> "to invoke such a rule investors must show that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure. Plaintiffs do not and could not contend that Midwest had actual knowledge of Nay's fraudulent escrow scheme. And, as our analysis of Midwest's section 6 duty of self-regulation demonstrates, Midwest adequately satisfied its duty of inquiry and had no reason to know of or suspect Nay's fraudulent escrow scheme. Failing proof that Midwest knew or should have known of Nay's fraud we need not further our inquiry into the other elements of a claim for aiding and abetting solely by inaction." (503 F.2d at 374)

Even assuming *arguendo* that partners of FID or others made fraudulent statements or omissions to plaintiffs, there is not one scintilla of evidence which indicates that the Exchange was aware of any alleged misrepresentations or omissions, or that the Exchange took any affirmative action to encourage the fraudulent statements. Since the Exchange provided no assistance or encouragement to any alleged violations of Rule 10b-5--let alone substantial assistance or encouragement—the Exchange cannot be found liable as an aider and abettor.

Plaintiffs appear to base their contention that the Exchange had a duty to disclose on cases in which there was active solicitation by the defendant. (Br. 42-45) In *Fischer* v. *New York Stock Exchange,* 408 F.Supp. 745 (S.D.N.Y. 1976), the district court denied the Exchange's motion, made before answering, to dismiss or for summary judgment. There, subordinated lenders to the firm of Pickard & Co.,

Incorporated, alleged that the Exchange directly had participated in the negotiations leading to their investment because an Exchange vice president personally prevailed upon them to invest. (408 F.Supp. at 749, 751) The court declined to grant summary judgment until the lenders at least had an opportunity for discovery. (*id.* at 751) Here, the record after trial shows that there was no communication between the Exchange and any plaintiff. The other cases cited by plaintiffs are similarly distinguishable. In each, the defendant was an active participant in the allegedly fraudulent transaction. In their analysis (Br. 44), plaintiffs confuse participation in events allegedly not disclosed ("December.... events") with participation in the allegedly fraudulent transaction (July merger).

Plaintiffs also cite (Br. 43) *Hughes* v. *Dempsey-Tegeler & Co.,* 534 F.2d 156 (9th Cir.), *cert. denied,* ____ U.S. ____ (1976), as authority for the proposition that the Exchange had a duty to disclose to them information which it had about FID. Plaintiffs' analogy to *Hughes* is inapposite. In *Hughes,* Robert Peck, an officer of Dempsey-Tegeler, provided the plaintiff with all the information that he received concerning that firm. The trial court there correctly ruled that such information constituted full disclosure. In this case, the trial court found that FID provided full disclosure to plaintiffs. Thus, the *Hughes* decision is authority only for the proposition that in the instant action plaintiffs have no claim against the Exchange.

The Exchange's approval of plaintiffs as partners of FIDGF did not give rise to a duty of disclosure. In *Weinberger* v. *New York Stock Exchange,* 403 F.Supp. 1020 (S.D.N.Y. 1975), the plaintiff claimed that approval by the Exchange of his limited partnership application made the Exchange a "participant" and created a duty on behalf of the Exchange to disclose any material adverse information which it knew about the firm. The court concluded otherwise:

> "[T]he rendering of approval of plaintiff's admission as a limited partner in Haupt created no duty of dis-

closure on behalf of Exchange which could give rise to a direct violation of section 10(b) and Rule 10b-5. See Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973); Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971); Fischer v. Kletz, 266 F.Supp. 180 (S.D.N.Y. 1967)." (403 F.Supp. at 1026)

There is simply no evidence to support plaintiffs' contention that the Exchange encouraged plaintiffs to invest in FIDGF. It was plaintiffs' deal and they could do it or not as they saw fit. It was not the Exchange's function to advise its members as to whether they were making wise investments. That was the business of plaintiffs and, as the trial court found, "[t]he events merely add up to an error in decision which wise businessmen often make and must live with." (Op. 19, 98a)

III

Plaintiffs Have Waived and Are Estopped from Asserting Their Claims Against the Exchange

As the trial court properly found, the only misrepresentations in this action were made by plaintiffs in their amended complaint. In the applications submitted by each plaintiff to the Exchange for approval as partner in FIDGF (613a, 618a, 623a), each plaintiff represented that he (a) had made an investigation of FID such as he deemed necessary; (b) was not relying upon the Exchange to provide or disclose any information concerning or relating to FID; and (c) that the Exchange should not be liable with regard to the plaintiffs' investment in FIDGF. Plaintiffs' testified at trial that those representations to the Exchange were truthful and accurate. (1950a, 2127a-2129a, 2179a) The amended complaint takes a contrary position.

In concluding that the Exchange had no duty of disclosure, the trial court found that the Exchange properly relied upon the representations of plaintiffs, who were sophisticated investors and members of the Wall Street community, that they "had fully informed themselves con-

cerning all the facts relating to FID and had decided to go forward with the merger, fully advised of all the facts" (Op. 14, 93a), and that "each was not relying upon NYSE to provide information and each agreed that NYSE had no responsibility to disclose to him any information concerning FID." (Op. 14-15, 93a-94a) The Exchange's reliance on plaintiffs' representations already has resulted in considerable injury and expense to it. Thus, plaintiffs are barred from pressing these claims against the Exchange by the principle of equitable estoppel.

This estoppel principle was well summarized by the Supreme Court in *Glus* v. *Brooklyn Eastern District Terminal*, 359 U.S. 231, 234 (1959):

> "The principle is that where one party has by his representations or his conduct induced the other party to a transaction to give him an advantage which it would be against equity and good conscience for him to assert, he would not in a court of justice be permitted to avail himself of that advantage. And although the cases to which this principle is to be applied are not as well defined as could be wished, the general doctrine is well understood and is applied by courts of law as well as equity where the technical advantage thus obtained is set up and relied on to defeat the ends of justice or establish a dishonest claim."

The Supreme Court also pointed out in *Glus* that the principle of estoppel is "older than the country itself" and should be applied, where appropriate, in the absence of clear statutory language or history to the contrary. 359 U.S. at 234. Since this principle applies to estop one party to a transaction from abandoning representations made to another party, it should also apply here, where the Exchange was not a party to the transaction but relied upon the representations made in its subsequent approval of plaintiffs as partners in FIDGF.

In addition, by their knowledge and conduct, plaintiffs have waived any rights which they might have had to recover. Plaintiffs admittedly were aware in early July

1970 of the alleged fraudulent misrepresentations and omissions in connection with their July 2, 1970 investment in FIDGF, yet they chose to maintain their capital in FIDGF and knowingly reinvested their capital on December 31, 1970. To allow plaintiffs to recover under such circumstances would defeat the purposes of the Securities Exchange Act. *Black* v. *Riker-Maxson Corp.*, 401 F.Supp. 693, 699 (S.D.N.Y. 1975). As the Court of Appeals for the Ninth Circuit stated in *Royal Air Properties* v. *Smith*, 312 F.2d 210, 213-214 (9th Cir. 1962) and 333 F.2d 568 (9th Cir. 1964):

> "The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act."

Contrary to plaintiffs' assertions (Br. 58-60), the application of equitable estoppel and waiver of plaintiffs' right to recover are not prohibited by Section 29(a) of the Exchange Act, 15 U.S.C. § 78cc(a). That provision voids any "condition, stipulation or provision binding any person to waive compliance" with the Act. It does not speak to the availability as a defense to a lawsuit of estoppel and waiver effected by plaintiffs' conduct. Courts consistently have held that equitable defenses such as estoppel and waiver are available under appropriate circumstances in actions brought to recover damages under the Exchange Act. *Hughes* v. *Dempsey Tegelor, supra; Hecht* v. *Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); *Royal Air Properties, Inc.* v. *Smith, supra; Straley* v. *Universal Uranium and Milling Corp.*, 289 F.2d 370 (9th Cir. 1961); *Black* v. *Riker-Maxson Corp., supra.*

Moreover, the non-waiver of compliance provision was designed to prevent the device of boiler plate clauses exempting financial houses from statutory liabilities, and was not designed to interfere with the freedom of sophisticated, fully-informed brokers, who had carefully negotiated transactions they knew to be risky, from acknowledging their awareness of the risks or their ability to assume them. See, *e.g, Coenen* v. *R. W. Pressprich & Co.*, 453 F.2d 1209, 1213-14 (2d Cir.), *cert. denied,* 406 U.S. 949 (1972); *Axelrod & Co.*

v. *Kordich, Victor & Neufeld,* 451 F.2d 838, 842-43 (2d Cir. 1971); *Brown* v. *Gilligan, Will & Co.,* 287 F.Supp. 766, 771-72 (S.D.N.Y. 1968).

IV

Even if Fraud Were Committed, Plaintiffs Cannot Recover Because the Alleged Damages Were Not Proximately Caused by the Alleged Fraud

In order to prove a claim under Rule 10b-5, plaintiffs must prove that any damages which they allegedly suffered were proximately caused by the fraudulent misrepresentations or omissions. *Globus* v. *Law Research Service, Inc.,* 418 F.2d 1276, 1292 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970); *Black* v. *Riker-Maxson Corp., supra.* Plaintiffs cannot satisfy that element of their burden of proof, since any monetary injury which they may have suffered was proximately caused, not by any alleged fraud, but by plaintiffs' own decisions in December, 1970, to invest again in FIDGF while they had full knowledge of the facts and the ability to withdraw, as did many of their partners.

Even assuming that plaintiffs had been induced by alleged misrepresentations of FID to invest in FIDGF on July 2, 1970, plaintiffs admittedly knew by the end of July that they had been "misled." As professionals in the securities industry, they, and the attorneys acting on their behalf, knew that if they had been misled, then and there (late July, 1970), they could have rescinded their transaction, either through arbitration as was provided in the merger agreement, or in a court of law.

Furthermore, plaintiffs would have suffered none of their alleged damage if they exercised the provisions in the merger agreement permitting them to withdraw their capital on December 31, 1970. By the beginning of December, 1970, plaintiffs were fully apprised of, and intricately involved in, the operational and net capital problems of FIDGF. Yet, rather than withdraw their capital as a number of other former Hirsch partners did, plaintiffs knowingly reinvested the bulk of their monies in FIDGF as subordinated capital. Under such circumstances, plaintiffs cannot prove that any fraudulent misrepresentations

or omissions prior to July 2, 1970 were the proximate cause of their alleged losses.

V

Plaintiffs Have Not Proven Any Damages

Plaintiffs have the burden of proving with certainty that they suffered actual damages. *Pierre J. LeLandais & Co., Inc.* v. *Mids-Atron, Inc.*, CCH Fed. Sec.L.Rep. ¶ 95,539 (2d Cir. 1976). However, plaintiffs at trial failed to submit any proof by which their damages, if any, could be computed.

Assuming *arguendo* that plaintiffs can prove a claim for fraud, that claim attaches only to their July 2, 1970 investment transaction. No claim for any other transaction has been asserted. Plaintiffs' damage claims for their July 2 transaction must be limited to any losses incurred in the value of their investments in FIDGF prior to December 31, 1970.

In December 1970, plaintiffs elected to forego rights which they had under the July 2, 1970 agreement to terminate their investments in FIDGF. At that time, plaintiffs entered into new investment agreements with terms more favorable to them. Plaintiffs' failure to extricate their capital invested in FIDGF under the July 2, 1970 agreement and their decision to enter into these new investment agreements with FIDGF constituted transactions separate and distinct from the July 2 transactions. There is no doubt that plaintiffs knew the full state of affairs at FIDGF at the time they entered into their new investments with FIDGF in December, 1970. Thus, plaintiffs' damages must be restricted to the diminution in the value of their investment during the period from July 2, 1970 until December 31, 1970. Furthermore, the "value" of plaintiffs' investments cannot be measured, because in addition to monies put into FIDGF on plaintiffs' behalf, that "value" includes plaintiffs' proportional share of Hirsch & Co. liabilities assumed by FIDGF. Plaintiffs have failed to submit any proof of the "value" of their investment or their alleged damages.

VI

The Trial Court Properly Exercised Its Discretion in Denying Plaintiffs' Motion to Amend to Allege a Claim under Section 6 or to Otherwise Pursue Such a Claim at Trial

A. The amended complaint does not plead a claim under Section 6

Plaintiffs contend that the trial court need never have reached the issue of whether they should be granted leave to amend at trial to assert a claim against the Exchange under Section 6 of the Exchange Act, since the amended complaint purportedly already pleaded a sufficient claim alleging violation of Section 6. (Br. 60) Both the pleadings and the prior history of the action belie this contention.

In April 1972, prior to answering the complaint, the Exchange moved to compel a more definite statement, requesting, among other things, that plaintiffs be required to file an amended complaint which would plead, *inter alia*,

> "(b) What statute or principle or common law gives to plaintiffs a claim upon which relief can be granted against defendant New York Stock Exchange, Inc." (1074a)

Plaintiffs first responded with an affidavit of one of their attorneys (Richard Spinogatti, Esq.) seeking to stave off the motion by assuring the Exchange that plaintiffs relied only on Sections 10(b) and 17 of the Securities Exchange Act of 1934: "In answer to [this] question, I assert that Section 10b . . . the rules and regulations . . . promulgated thereunder and Section 17 . . . are such statutes". (1087a-1088a) Despite these assurances, the district court granted the Exchange's motion. Subsequently, plaintiffs filed an amended complaint alleging only violations of Section 17 of the Securities Act, 15 U.S.C. § 77q, Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and certain common law claims asserted under the doctrine of pendent jurisdiction.

The first notice that the Exchange had that plaintiffs thought they were prosecuting a Section 6 claim surfaced

in plaintiffs' counsel's affidavit and memorandum of law, dated April 4, 1975, in opposition to defendants' motion for summary judgment. In those submissions, plaintiffs' counsel blithely contended that Section 6 claims already were pleaded. However, the amended complaint clearly shows that fraud claims—and only fraud claims— were asserted against the Exchange. Nowhere does the amended complaint mention, or even allude to, an alleged failure by the Exchange to regulate FID properly, which is the gravamen of a cause of action under Section 6. *Baird* v. *Franklin,* 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944); *Hochfelder* v. *Midwest Stock Exchange, supra.*

Under the circumstances, where plaintiffs specifically were directed to designate the statutory sections under which they were proceeding, and they made no mention of Section 6, plaintiffs' contention that the amended complaint alleged a claim under Section 6 which satisfied the notice pleading requirements of Rule 8 of the Federal Rules of Civil Procedure will not wash. The test of compliance with Rule 8 is whether the pleadings give "fair notice" of the claim asserted so as to enable the adverse party to defend the action. *Conley* v. *Gibson,* 355 U.S. 41, 47 (1955).

B. Plaintiffs properly were denied leave to amend the amended complaint at trial

The trial court properly exercised its discretion in denying plaintiffs' motion for leave to amend the amended complaint on the first day of trial.

> "Well, the motion [for leave to amend] is denied, I am denying it because I think it is not fair to, on the eve of trial, to introduce an entirely new theory which had it been raised previously the defendant might have been able to meet it by a motion for summary judgment as they did in regard to the other claim." (1123a)

In challenging the trial court's denial of their motion to amend, plaintiffs have misstated the issue. (Br. 63-65) The issue is not whether the trial court erred, but whether its ruling constituted an abuse of its discretion. *John Birch Society* v. *NBC,* 377 F.2d 194, 199 (2d Cir. 1967); *Vine* v.

Beneficial Finance Co., 374 F.2d 627, 637 (2d Cir.), *cert. denied,* 389 U.S. 370 (1967).

It is within the discretion of the trial court to deny a motion to amend a pleading where there is a showing of 1) undue delay in seeking amendment or 2) undue prejudice, or 3) futility of the proposed pleadings. See, *e.g., Foman* v. *Davis,* 371 U.S. 178 (1962); *Feldman* v. *Lifton,* 64 F.R.D. 539, 542 (S.D.N.Y. 1974). Unnecessary delay in seeking amendment, coupled with prejudice to defendant, justifies a trial court's denial of a motion to amend after extensive discovery proceedings and on the eve of trial or at trial. *Wheeler* v. *West India S.S. Co.,* 205 F.2d 354 (2d Cir.), *cert. denied,* 346 U.S. 889 (1953); *Bradick* v. *Israel,* 377 F.2d 262 (2d Cir.), *cert. denied*, 389 U.S. 858 (1967).

In *Rogers* v. *Valentine,* 426 F.2d 1361 (2d Cir. 1970), this Court ruled that the district court properly denied motions to amend when the plaintff previously had specified the statutes under which he was proceeding in a submission to the court. In *Rogers,* as in this action, one year prior to trial plaintiff had announced an intention to seek leave to amend the complaint but subsequently had disavowed that intention and took no action to amend until immediately prior to trial. This Court said:

> "The district court properly focused on the issue of whether prejudice would result from granting appellant leave to amend his complaint. Under the circumstances of this case, including appellant's long delays and repeated representations as to the basis of his action, we believe the trial judge's denial of appellant's requests to amend was not an abuse of discretion." (citations omitted) (426 F.2d at 1363)

Plaintiffs here failed to show any compelling justification for delay in moving to amend the amended complaint. Any contention that the proposed amendment was motivated by new facts which came to light during discovery and were brought immediately to the attention of the court must be rejected, since discovery had ended one year prior to trial. Furthermore, according to plaintiffs' counsel at trial, new "developments" in the law were the basis for the proposed amendment.

"Mr. Camhy: . . . What happened, your Honor, was that since the date when this case was originally brought there were decisions in the Dempsey-Tegeler case and in the Sloan case and in other cases which began to recognize a 6-B right which had, to my knowledge at least not been asserted before. So while we were preparing the same case we realized that we have another statutory leg.

"Now during the course of this case the defendants --

"The Court: When did you realize that, Mr. Camhy? Yesterday?

"Mr. Camhy: No, approximately six months ago, your Honor, or perhaps a year ago. A year ago, yes. When Mr. --" (1116a)

However, the availability of a private right of action under Section 6 has been known to exist since this Court spoke in 1944. *Baird* v. *Franklin, supra.* Counsel's alleged misconception of the law is no excuse for the late presentation of an alternative theory of relief. *See, e.g. Troxel Manufacturing Co.* v. *Schwinn Bicycle Co.,* 489 F.2d 968 (6th Cir. 1973), *cert. denied,* 416 U.S. 939 (1974); *Nevel* v. *Ford Motor Co.,* 439 F.2d 251, 257 (5th Cir. 1971).

The Exchange would have been prejudiced if plaintiffs had been permitted to interject the proposed Section 6 claim at trial. Even hurried and extensive discovery proceedings would not be sufficient to cure the prejudice. Defense of a claim alleging that the Exchange failed properly to regulate FID involves factual proof of a technical nature which would require close scrutiny of the financial and operational records of FID and the alternatives available to its management and to the Exchange. However, through the passage of time the documents had been scattered throughout the United States. Similarly, FID officers and employees who had first-hand knowledge of the financial and operational condition of the firm had scattered across the country. One Exchange officer, Fred J. Stock, who played an important role in the regulation of FID, died in August, 1973. His deposition was never taken because it had no relevance to the disclosure case.

Furthermore, the Exchange conducted no discovery on the facts which purportedly underlie allegations re-

garding the Exchange's failure to regulate properly FID. The Exchange made no inquiry of plaintiffs, the FID principals, or Haskins & Sells in respect to regulatory issues. The Exchange undertook no document discovery of FID or Haskins & Sells. It concentrated its discovery on disclosure issues alone—who said what, to whom, and when. A paramount purpose of the pretrial discovery provisions of the Federal Rules of Civil Procedure is to allow a party to protect against unnecessary surprise at trial. To have required the Exchange to defend against claims at trial without having had any opportunity for discovery on those claims would be contrary to the purpose and spirit of the Federal Rules.

In addition, leave to amend was denied properly since the proposed claim was subject to challenge as insufficient as a matter of law. The events which gave rise to the proposed claim occurred in 1969 and 1970. If, as the Exchange has contended, the proper limitations period for a claim under Section 6 is provided by New York CPLR § 214(a), which bars actions "to recover upon a liability. . . . created or imposed by statute unless brought within three years," plaintiffs' proposed amendment would be time-barred. Furthermore, Kohns and Mundheim, who had general and limited partnership interests in FIDGF, and Hirsch, who had a limited partnership interest, would lack standing if, as the Exchange contends, only public customers of a member firm have standing to sue under Section 6.[10]

VII

The District Court Correctly Ruled that Kohns and Mundheim Had No Federal Securities Law Claim for Their General Partnership Interests

Plaintiffs now attack the district court's ruling (77a) that the general partnership interests of Kohns and Mundheim were not covered by Sections 10(b) and 17. Plain-

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10. The issues of standing to sue under Section 6 and the proper limitations period to be applied to claims under Section 6 are *sub judice* before this Court in Lank v. New York Stock Exchange, Docket No. 76-7243 (2d Cir. 1976). The issues have also been argued by the Exchange in support of affirmance of the result below in Arneil v. Ramsey, Docket No. 76-7305 (2d Cir. 1976), also *sub judice*.

tiffs' argument does not question the determination that Kohns' and Mundheim's general partnership interest were not securities, but argues that claims by the same party in the same action involving both securities (plaintiffs' limited partnership interests) and non-securities (Kohns' and Mundheim's general partnership interests) are both properly brought under Sections 10(b) and 17. Plaintiffs rely on *Errion* v. *Connell,* 236 F.2d 447, 454 (9th Cir. 1956), which the district court distinguished as holding that a federal court "may exercise *pendent* jurisdiction over state common law claims concerning non-securities." The district court here did exercise such pendent jurisdiction.

Plaintiffs' argument is faulty on two grounds. First, the district court correctly determined that a claim involving non-securities is not properly brought under the federal securities laws. Secondly, under the test established in *SEC* v. *W. J. Howey Co.,* 328 U.S. 293, 298-99 (1946), the factors that rendered the general partnership interests non-securities (e.g., the active management role played by both Kohns and Mundheim in FIDGF), are equally applicable to Kohns' and Mundheim's limited partnership interests. Since the district court erred in treating Kohns' and Mundheim's limited partnership interests as securities, Kohns and Mundheim have no basis for boot strapping any of their claims within the federal securities laws.

CONCLUSION

The judgment of the trial court should be affirmed.

December 20, 1976

Respectfully submitted,

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TONI C. LICHSTEIN

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

- x

HOWARD C. HIRSCH, PAUL L. KOHNS and MARSHALL S. MUNDHEIM,	:
Plaintiffs-Appellants,	:
-against-	:
EDMOND duPONT, WALLACE C. LATOUR, MILTON A. SPEICHER, FRANCIS I. duPONT & CO., F.I. duPONT GLORE FORGAN & CO. and duPONT GLORE FORGAN INCORPORATED,	: AFFIDAVIT OF SERVICE Docket No. 76-7428
Defendants,	:
and	:
HASKINS & SELLS and NEW YORK STOCK EXCHANGE, INC.	:
Defendants-Appellees.	:

- x

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

DIANE PERESS, being duly sworn, deposes and says:

I am over the age of 18 years and am not a party to this action.

On December 20, 1976, I served the brief for defendant-appellee New York Stock Exchange, Inc., herein, upon Cahill Gordon & Reindel, by delivering two true copies thereof to them at their offices, 80 Pine Street, New York, New York, and leaving such copies there personally with Mr. Allen Chiu, the person in charge of the office.

Diane Peress

Sworn to before me this

20th day of December, 1976.

Louis A. Wolf

LOUIS A. WOLF
NOTARY PUBLIC, State of New York
No. 30-5723500
Qualified in Nassau County
Certificate Filed in New York County
Commission Expires March 30, 1978

2 copies